



**DELAWARE STATE LOTTERY**

Financial Statements

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)

# **DELAWARE STATE LOTTERY**

## **Financial Statements**

**June 30, 2006 and 2005**

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## Independent Auditors' Report

Wayne Lemons, Director of the Delaware State Lottery and  
Richard S. Cordrey, Secretary of Finance, State of Delaware:

We have audited the accompanying balance sheet of the Delaware State Lottery (the Lottery) as of June 30, 2006, and the related statements of revenue, expenses and change in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying financial statements of the Lottery as of June 30, 2005, were audited by other auditors whose report thereon dated September 1, 2005, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Delaware as of June 30, 2006, and the changes in its financial position for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the 2006 financial statements referred to above present fairly, in all material respects, the financial position of the Delaware State Lottery as of June 30, 2006, and its changes in financial position and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 22, 2006, on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

KPMG LLP

September 22, 2006



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**Independent Auditors' Report on Internal Control over Financial Reporting  
and on Compliance and Other Matters Based on an Audit of Financial  
Statements Performed in Accordance with *Government Auditing Standards***

Wayne Lemons, Director of the Delaware State Lottery and  
Richard S. Cordrey, Secretary of Finance, State of Delaware:

We have audited the financial statements of the Delaware State Lottery (the Lottery) as of and for the year ended June 30, 2006, and have issued our report thereon dated September 22, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control over Financial Reporting**

In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Lottery in a separate letter dated September 22, 2006.

This report is intended solely for the information and use of the Secretary of Finance, Lottery management, the Office of the Governor, the Office of the Controller General, the Office of the Attorney General, the Office of Management and Budget, and the Office of the Auditor of Accounts, and is not intended to be and should not be used by anyone other than these specified parties. However, under 29 Del. C, Section 10002(d), this report is public record and its distribution is not limited.

**KPMG LLP**

September 22, 2006

**DELAWARE STATE LOTTERY**  
**Management's Discussion and Analysis**  
**June 30, 2006 and 2005**

The management of the Delaware State Lottery (hereinafter referred to as the Lottery) offers this narrative overview and analysis of the Lottery's financial activities for the years ended June 30, 2006 and 2005, which should be read in conjunction with the Lottery's basic financial statements.

**Overview of the Basic Financial Statements**

This discussion and analysis is intended to serve as an introduction to the Lottery's basic financial statements. Since the Lottery is an enterprise fund of the State of Delaware, these financial statements are presented in a manner similar to a private-sector business. As required by accounting principles generally accepted in the United States (GAAP), current year's revenues are recorded when earned and expenses are recorded as they are incurred, regardless of when the cash is received or disbursed.

The balance sheet presents information on all of the Lottery's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets serve as a relative indicator of the change in financial position of the Lottery.

The statement of revenue, expenses and change in net assets shows the result of the Lottery's total operations during the fiscal year and reflects both operating and nonoperating activities. Changes in net assets (increases or decreases) reflect the current fiscal period's operating impact upon the overall financial position of the Lottery.

The statement of cash flows provides a detailed analysis of all sources and uses of cash. The direct method of cash flows is presented, ending with a reconciliation of operating income to net cash provided by operating activities. The statement of cash flows is divided into three activities sections—operating, noncapital financing, and investing.

Notes to the basic financial statements contain additional information, and often offer explanations to the basic financial statements. The notes are intended to assist the reader in understanding the Lottery's basic financial statements.

**DELAWARE STATE LOTTERY**  
Management's Discussion and Analysis  
June 30, 2006 and 2005

**Condensed Balance Sheets**

**Table 1**  
**Balance Sheets**  
(In millions)

Assets	June 30		
	2006	2005	2004
Cash and cash equivalents	\$ 6.1	5.8	10.9
Accounts receivable, net of allowance of \$0.7, \$0.7, and 0.7, respectively	8.7	6.4	4.5
Investments	8.5	9.9	11.8
Prepaid expenses	—	0.5	0.4
Capital assets, net	0.1	0.2	0.3
Deposit with Multi-State Lottery	1.9	1.7	1.7
Total assets	\$ 25.3	24.5	29.6
<b>Liabilities and net assets</b>			
<b>Liabilities:</b>			
Prizes liability, including \$8.5, \$9.9, and \$11.8, respectively, of prize installment obligation	\$ 12.5	13.0	17.1
Accounts payable and accrued liabilities	5.8	4.5	8.5
Multi-State Lottery Reserve	1.9	1.7	1.7
Due to the State of Delaware	4.1	4.4	1.7
Total liabilities	24.3	23.6	29.0
<b>Net assets:</b>			
Invested in capital assets	0.1	0.2	0.3
Unrestricted	0.9	0.7	0.3
Total net assets	1.0	0.9	0.6
Total liabilities and net assets	\$ 25.3	24.5	29.6

The Lottery's accounting periods are predicated on a 4-4-5 week cycle except at year end when the closing date includes additional days up to and including June 30th. These extra days amounted to three in 2004, four in 2005 and five in 2006. Correspondingly, the additional days in 2005 and 2006 are reflected in the additional accounts receivable.

Investments and the related prize installment obligations have been reduced over the years as a result of the existing annuities maturing and the Lottery no longer utilizing annuities for prize payments.

**DELAWARE STATE LOTTERY**  
Management's Discussion and Analysis  
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**Revenue**

**Table 2**  
**Revenue**  
(In millions)

	Year ended June 30		
	2006	2005	2004
Play 3	\$ 27.6	27.6	28.0
Play 4	17.2	16.8	16.7
Multi Win Lotto	7.5	4.0	—
Lotto	—	11.5	8.9
Powerball	38.0	24.2	28.6
Powerplay	2.8	1.3	1.4
Instant games	31.4	28.7	25.0
Traditional games revenue	124.5	114.1	108.6
Video lottery, net	603.5	575.2	532.3
Total revenue	\$ 728.0	689.3	640.9

Table 2 above compares revenue for each lottery game category. Total Lottery revenue for fiscal year 2006 was \$38.7 million or 5.6% higher than for fiscal 2005, which was \$48.4 million or nearly 8% higher than 2004.

The all cash Lotto game was discontinued at the beginning of fiscal 2006. Multi-Win Lotto, which was introduced during fiscal 2005 was operational for all of 2006, thus resulting in increased sales.

Fiscal 2006 Powerball and Powerplay sales that are typically driven by the size of the jackpot, were 57% and 115% higher than fiscal 2005 respectively as a result of substantially higher jackpot levels attained during 2006. In contrast, 2005 sales decreased \$4.5 million or 18% from 2004 since 2005 had only one jackpot higher than \$200 million compared to three during 2004.

Instant games continue to show a steady increase. The "cooperative services" agreement that the Lottery signed with its vendor for instant games continued to produce positive results. The vendor, in conjunction with the Lottery, continued to offer more attractive products. The Lottery also decided to shorten the life cycle of games offered, and increased the introduction of higher price point tickets as surveys indicated that higher price points with higher prize levels were more attractive to the playing public.

Video Lottery also continued its steady increase due to the addition of machines and the extension of operating hours.



**DELAWARE STATE LOTTERY**  
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**Cost of Games**

**Table 3**  
**Cost of Games**  
(As a % of Sales)

	Year ended June 30		
	2006 % of sales	2005 % of sales	2004 % of sales
Commission expense	40.6%	40.9%	40.8%
Gaming vendor fees and costs	5.6	5.7	5.7
Prize expense	8.9	8.7	8.3

Commission expense includes payments to Lottery retailers for selling lottery tickets and to video lottery agents for operation of video lottery facilities. Commission expense as a percent of sales remained relatively unchanged for all three years.

Gaming vendor fees and costs include costs of the central system used to monitor and collect pertinent data for the on-line and the video lottery system and costs of leasing video lottery terminals from gaming vendors. Gaming vendor fees and costs remained relatively unchanged as a percent of sales for all three years.

**Prize Expense**

**Table 4**  
**Prize Expense, Net of Reversions**  
(In millions)

	Year ended June 30		
	2006	2005	2004
Play 3	\$ 12.6	12.5	15.0
Play 4	8.3	8.0	7.8
Multi Win Lotto	4.2	2.5	—
Lotto	—	7.0	0.8
Powerball	18.4	11.3	13.8
Powerplay	1.4	0.6	0.7
Instant games	20.0	17.9	15.1
Total prize expense	\$ 64.9	59.8	53.2

Table 4 above compares prize expense for each Lottery game category for the past three years. In general, prize expense by game will increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, the prize expenses for the Play 3 and Play 4 games are impacted by the luck of the draw and actual prize payment is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. Prize expense for the instant game product category is

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controllable for the most part, by printing a predetermined number and value of winning tickets for each instant game.

Prize expense for 2006 compared to 2005 and 2005 compared to 2004 are commensurate with the increases in sales during the same periods.

**Operating Expenses**

**Table 5**  
**Operating expenses**  
(In millions)

	<b>Year ended June 30</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Operating expenses	\$ 7.7	7.2	5.6

The main reason for the \$0.5 million increase in 2006 when compared to 2005 and the \$1.6 million increase in 2005 when compared to 2004 was the fixed usage fee that the Lottery is required to pay for installed franchise games at the three video lottery facilities.

**Nonoperating Expenses**

**Table 6**  
**Nonoperating expenses**  
(In millions)

	<b>Year ended June 30</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Contributions to the Delaware Standardbred Breeder's program	\$ 3.0	3.0	3.0
Contributions to the State of Delaware	316.0	297.9	281.2
Total nonoperating expenses	\$ 319.0	300.9	284.2

Increases in cash contributions to the State of Delaware were consistent with Lottery revenue increases.

# DELAWARE STATE LOTTERY

## Balance Sheets

June 30, 2006 and 2005

<b>Assets</b>	<b>2006</b>	<b>2005</b>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 6,122,398	5,803,835
Accounts receivable, net of allowance of \$726,248 and \$705,122, respectively	8,723,164	6,443,582
Investments – restricted for payment of prize liabilities	2,232,690	2,456,758
Prepaid expenses	40,280	488,514
<b>Total current assets</b>	<b>17,118,532</b>	<b>15,192,689</b>
<b>Capital assets, net</b>	<b>68,830</b>	<b>199,192</b>
Investments – restricted for payment of prize liabilities	6,223,034	7,394,490
Deposit with Multi-State Lottery	1,898,623	1,700,747
<b>Total noncurrent assets</b>	<b>8,190,487</b>	<b>9,294,429</b>
<b>Total assets</b>	<b>\$ 25,309,019</b>	<b>24,487,118</b>
<b>Liabilities and net assets</b>		
<b>Current liabilities:</b>		
Prizes liability, including \$2,232,690 and \$2,456,758, respectively, of prize installment obligations	\$ 6,309,755	5,540,534
Accounts payable and accrued liabilities	5,811,428	4,532,331
Due to the State of Delaware	4,122,629	4,385,113
<b>Total current liabilities</b>	<b>16,243,812</b>	<b>14,457,978</b>
<b>Multi-State Lottery reserve</b>	<b>1,898,623</b>	<b>1,700,747</b>
<b>Prize installment obligations, noncurrent</b>	<b>6,223,034</b>	<b>7,394,490</b>
<b>Total liabilities</b>	<b>24,365,469</b>	<b>23,553,215</b>
<b>Net assets:</b>		
Invested in capital assets	68,830	199,192
Unrestricted	874,720	734,711
<b>Total net assets</b>	<b>943,550</b>	<b>933,903</b>
<b>Total liabilities and net assets</b>	<b>\$ 25,309,019</b>	<b>24,487,118</b>

See accompanying notes to financial statements.

# **DELAWARE STATE LOTTERY**

## Statements of Revenue, Expenses, and Change in Net Assets

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Revenue:		
Video lottery, net	\$ 603,501,083	575,234,109
On-line games	93,137,268	85,361,356
Instant games	<u>31,354,597</u>	<u>28,695,737</u>
Total revenue	<u>727,992,948</u>	<u>689,291,202</u>
Cost of games:		
Video lottery commissions	287,527,716	274,662,888
Prize costs, net of reversions	64,878,620	59,829,996
Gaming vendor fees and costs	40,835,730	39,308,123
On-line and instant games commissions	8,042,530	7,062,069
Sales aids	<u>24,243</u>	<u>8,895</u>
Total cost of games	<u>401,308,839</u>	<u>380,871,971</u>
Gross profit	<u>326,684,109</u>	<u>308,419,231</u>
Operating expenses:		
Advertising and promotions	2,408,790	2,517,481
Payroll and related benefits	1,647,545	1,569,045
Other general and administrative	3,502,066	2,974,011
Depreciation expense	<u>130,362</u>	<u>130,361</u>
Total operating expenses	<u>7,688,763</u>	<u>7,190,898</u>
Operating income	318,995,346	301,228,333
Nonoperating expenses:		
Contributions to the Delaware Standardbred Breeder's Program	3,000,000	3,000,000
Contributions to the State of Delaware	<u>315,985,699</u>	<u>297,921,666</u>
Change in net assets	9,647	306,667
Net assets at beginning of year	<u>933,903</u>	<u>627,236</u>
Net assets at end of year	\$ <u><u>943,550</u></u>	<u><u>933,903</u></u>

See accompanying notes to financial statements.

# **DELAWARE STATE LOTTERY**

## Statements of Cash Flows

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Receipts from customers	\$ 725,713,366	687,386,396
Payments to vendors for goods and services	(46,081,091)	(44,579,856)
Payments to employees for services	(1,648,089)	(1,512,367)
Payments for prizes	(65,280,855)	(63,992,751)
Payments for commissions	(294,532,109)	(286,021,446)
Net cash provided by operating activities	<u>318,171,222</u>	<u>291,279,976</u>
Cash flows from noncapital financing activities:		
Contributions to the Delaware Standardbred Breeder's Program	(3,000,000)	(3,000,000)
Contributions to the State of Delaware	(316,248,183)	(295,259,119)
Net cash used in noncapital financing activities	<u>(319,248,183)</u>	<u>(298,259,119)</u>
Cash flows from investing activities:		
Proceeds from maturity of investments	<u>1,395,524</u>	<u>1,934,684</u>
Net cash provided by investing activities	<u>1,395,524</u>	<u>1,934,684</u>
Net (decrease) increase in cash and cash equivalents	318,563	(5,044,459)
Cash and cash equivalents at beginning of year	<u>5,803,835</u>	<u>10,848,294</u>
Cash and cash equivalents at end of year	\$ <u><u>6,122,398</u></u>	<u><u>5,803,835</u></u>
Reconciliation of operating income to net cash from operating activities:		
Operating income	\$ 318,995,346	301,228,333
Adjustments to reconcile operating income to net cash from operating activities:		
Depreciation expense	130,362	130,361
Changes in operating assets and liabilities:		
Accounts receivable, net	(2,279,582)	(1,904,806)
Prepaid expenses	448,234	(65,812)
Deposit with Multi-State Lottery	(197,876)	17,208
Prizes liability	(402,235)	(4,162,755)
Accounts payable and accrued liabilities	<u>1,476,973</u>	<u>(3,962,553)</u>
Net cash provided by operating activities	\$ <u><u>318,171,222</u></u>	<u><u>291,279,976</u></u>

See accompanying notes to financial statements.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2006 and 2005

#### (1) Summary of Significant Accounting Policies

##### (a) *Legislative Enactment*

The Delaware State Lottery (the Lottery) was established by Enabling Legislation (the Legislation) passed on May 31, 1974, by the General Assembly of the State of Delaware (the General Assembly) under the authority of the Governor's Office and under the supervision of a Director. In July 1976, the Lottery was transferred to the Office of the Secretary of Finance. The Director has the power and duty to establish rules for conducting games, including the type and number of games, the price of tickets, the number and amounts of winning tickets, the manner of selecting winning tickets, the manner of prize payment, frequency of drawings, locations and methods for the sale of tickets, procedures for licensing of retailers and all other functions related to the operation of the Lottery.

The Legislation provides that for the nonvideo lottery games at least 45% of total revenue shall be used to pay prizes, operating expenses shall not exceed 20% of total revenue and at least 30% of total revenue will be paid to the General Fund of the State of Delaware (the State). Enabling legislation for video lottery was enacted on July 16, 1994 and provides that for the video lottery games at least 87%, but not more than 95% (unless approved by the Director), of total proceeds on an average annual basis shall be used to pay prizes.

##### (b) *Reporting Entity*

The Delaware State Lottery (reporting entity) is an enterprise fund of the State of Delaware.

##### (c) *Basis of Presentation*

In accordance with accounting principles generally accepted in the United States, the financial statements are prepared on the accrual basis of accounting, which requires recognition of revenues when earned and expenses when incurred. The Lottery has elected not to apply all Financial Accounting Standards Board statements and interpretations issued after November 30, 1989, in accordance with Government Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*.

##### (d) *Cash and Cash Equivalents*

Cash and cash equivalents consist of deposits held in bank accounts and highly liquid overnight investment accounts, as well as deposits held by the State of Delaware to fund future nonprize costs during the next month.

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2006 and 2005

### (e) *Accounts Receivable*

Accounts receivable consist primarily of unsettled balances due to the Lottery from the racetracks for video lottery, and from retailers, which principally include grocery and convenience stores serving as the primary distribution channel for traditional lottery sales (on-line and instant games) to the general public.

	<u>2006</u>	<u>2005</u>
Receivables:		
Accounts	\$ 9,449,412	7,148,704
Total receivables	9,449,412	7,148,704
Allowance for doubtful accounts	(726,248)	(705,122)
Total receivables, net	<u>\$ 8,723,164</u>	<u>6,443,582</u>
Amounts not scheduled for collection during the subsequent year	\$ —	—

### (f) *Investments*

Investments consist of annuity contracts purchased from insurance companies to fund future prize payments, and are carried at amortized cost as non-participating investment contracts. The practice of purchasing and holding annuity contracts to fund future prize obligations is no longer employed by the Lottery, as investment amounts reported represent annuity contracts whose most recent purchase was during 1998. It is the Lottery's policy to hold all investments of this nature that were purchased to fund prize obligations until maturity. All investments will have matured as of February 16, 2018; at which time such investments will no longer be reported by the Lottery.

### (g) *Capital Assets*

All purchases of capital assets, mostly computer equipment and furniture and fixtures, in excess of \$15,000 are capitalized and carried at cost. Depreciation is computed by using the straight-line method over the estimated useful life of ten years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal.

### (h) *Revenue Recognition*

Revenue from on-line games is recognized on the day of the drawing. Revenue from the sale of instant tickets is recognized when the book has been activated and when one of the following occurs:

- 85% of the related prizes of an activated book is paid;
- 90 days from the date of activation; or
- when the next pack of the same game is activated.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2006 and 2005

Revenue from video lottery sales is recognized, net of prizes paid, at the time the public plays the game.

All revenue that the Lottery reports is considered operating revenue.

(i) ***Prize Obligations***

Prize obligations for the on-line games are determined and recognized after each drawing is held. For the numbers games, winners are paid a certain amount depending upon the number of, or order of, winning numbers. Of every Multi Win Lotto sales dollar a fixed payment goes to fund the 9 lower prize levels with the balance going into the jackpot. If there are no jackpot winners in the Lotto game, the amount is carried forward until there is a winner. For the Powerball, 50% of the revenues are allocated to the prize pool.

Prize obligations related to instant games are recognized by taking the greater of prize cash disbursements or the historical estimates of claimed prizes. Disbursements for prizes, including installment prize awards, are charged against the obligations for unpaid prize awards. Prizes unclaimed after one year revert back to the Lottery and reduce the prize costs for the year. Such unclaimed monies are then remitted to the State of Delaware.

(j) ***Compensated Absences***

The Lottery has accrued a liability included in accounts payable and accrued liabilities for future absences, recognizing the obligation relating to services already rendered. This liability represents benefits accrued to Lottery employees for vacation earned as of year-end and sick leave estimated to be paid out at retirement for services rendered as of June 30, 2006. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or his estate is paid for unused vacation upon termination of employment. Employees earn 1.25 days of sick leave per month. The Lottery's obligation for sick leave credit is a maximum of 45 workdays. As of June 30, 2006 and 2005, the Lottery had liabilities of \$96,913 and \$111,268 for accrued vacation and \$125,086 and \$126,472 for accrued sick leave, respectively.

(k) ***Operating and Nonoperating Expenses***

Operating expenses generally result from providing services and producing and delivering goods in connection with the Lottery's principal ongoing operations. Operating expenses of the Lottery include personnel costs, contracted services, supplies, and depreciation. All expenses not meeting this definition are reported as nonoperating expenses.

(2) **Cash**

Cash and cash equivalents reported reflect three types of account balances: The Lottery deposit account, the Lottery prize account, and deposits held by the State of Delaware. Cash receipts and all cash transfers to other State agencies are made in and out of the Lottery deposit account. Prize disbursements are made out of the Lottery prize account. Cash held by the State of Delaware (Treasurer's Office), while identified for the Lottery, is maintained in an internal investment pool controlled by the State of Delaware.



## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2006 and 2005

Cash balances consisted of the following:

	June 30	
	2006	2005
On hand and in bank	\$ 4,292,078	4,366,625
Held by State of Delaware	1,830,320	1,437,210
	<u>\$ 6,122,398</u>	<u>5,803,835</u>

**(a) Custodial Credit Risk**

All deposits are required by State of Delaware law to be collateralized by direct obligations of, or obligations guaranteed by, the United States of America or other suitable obligations as determined by the State of Delaware's Cash Management Policy Board (the Board), unless the Board shall find such collateralization not in the best interest of the State. Additionally, the Board has determined that deposits need not be collateralized provided they are held in a bank that for the previous two years has had a return on total average assets of 0.5% or greater and has had an average capital ratio (total equity to total assets) of at least 5%. If the bank does not meet the aforementioned criteria, collateral must consist of one or more of the following:

- U.S. Government Securities;
- U.S. Government Agency Securities;
- Federal Home Loan Board Letters of Credit;
- State of Delaware Securities; or
- Securities of a political subdivision of the State of Delaware with a Moody's Investors service rating of "A" or better.

In addition, the bank must ensure that those securities pledged as collateral have a market value equal to or greater than 102% of the ledger balance(s) in the account(s) each day and ensure that securities pledged are identified as held in the State of Delaware's name and are segregated on the bank's records.

At June 30, 2006 and 2005, the bank in which amounts representing Deposits and Cash On Hand are maintained met the aforementioned State-mandated standards; thus alleviating the need for collateralization. Also, at June 30, 2006 and 2005, the financial institutions maintaining the State of Delaware's internal investment pool satisfied the aforementioned criteria; thus, the investments managed by those institutions do not require collateralization.

As of June 30, 2006 and 2005, the total bank balance of cash in all bank accounts was \$4,351,069 and \$4,481,898, respectively.

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2006 and 2005

### (3) Investments

Until April of 1998, annuity contracts were purchased from insurance companies to fund prizes of \$150,000 or more; payable on an installment basis. All investments reported on the balance sheet represent such annuities, and are carried on the balance sheet at amortized cost. The fair value of some of these investments is not easily determinable; however, it is the Lottery's intent to hold the investments until maturity. The Lottery remains liable for future periodic payments of deferred prize obligations (approximately \$8.5 million as of June 30, 2006) in the event that annuity issuers default on their obligations. Lottery investments as of June 30, 2006 and 2005 are considered uncategorized investments as it relates to custodial credit risk under GASB Statement No. 40, *Deposit and Investment Risk Disclosures*.

#### (a) Interest Rate Risk

Interest rate risk is the risk that changes in interest rates of debt instruments will adversely affect the value of an investment. Investments reported on the balance sheet are not subject to interest rate risk.

#### (b) Credit Risk and Concentration of Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. While the Lottery no longer utilizes the purchase of annuity contracts to fulfill prize obligations, the Lottery places no limit on the amount it may invest in any one issuer. As of June 30, 2006, the insurance companies with which the Lottery's investments in annuity contracts to pay future prize obligations are held were rated by A.M. Best Company and concentrated as follows:

<u>Insurance company</u>	<u>Total annuity contract values</u>	<u>Concentration</u>	<u>A.M. Best rating</u>
Sun America Life Insurance Company \$	109,385	1.29%	aa+ (superior)
Jefferson-Pilot Life Insurance Company	4,147,480	49.05%	aa (superior)
John Hancock Life Insurance Company	221,076	2.61%	aa+ (superior)
Metropolitan Life Insurance Company	2,182,360	25.81%	aa (superior)
Mutual of America Life Insurance Co.	880,713	10.42%	A+ (excellent)
New York Life Insurance Company	324,600	3.84%	aa+ (superior)
Ohio National Life Insurance Company	590,110	6.98%	aa- (superior)
Total investments in annuity contracts	<u>8,455,724</u>	<u>100.00%</u>	

# **DELAWARE STATE LOTTERY**

## **Notes to Financial Statements**

June 30, 2006 and 2005

### **(4) Capital Assets**

	<b>Beginning balance July 1, 2005</b>	<b>Increase</b>	<b>Decrease</b>	<b>Ending balance June 30, 2006</b>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,195,695	130,362	—	1,326,057
Total capital assets being depreciated, net	\$ 199,192			68,830
	<b>Beginning balance July 1, 2004</b>	<b>Increase</b>	<b>Decrease</b>	<b>Ending balance June 30, 2005</b>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,065,334	130,361	—	1,195,695
Total capital assets being depreciated, net	\$ 329,553			199,192

During the year ended June 30, 2006 and 2005, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2006 and 2005 was \$130,362 and \$130,361, respectively.

### **(5) Prize Obligations**

The following is a reconciliation of changes in the prize liability account, which includes the present value of prize installment obligations, for the fiscal years ended June 30, 2006 and 2005:

	<b>2006</b>	<b>2005</b>
Prize obligations, beginning of year	\$ 12,935,024	17,097,779
Prize payments	(65,280,855)	(63,992,751)
Prize costs, net of reversions	64,878,620	59,829,996
Prize obligations, end of year	\$ 12,532,789	12,935,024

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2006 and 2005

The Lottery pays the winners of certain jackpots in annual installments over periods that vary generally from 14 to 20 years. The future prize installment obligations payable as of June 30, 2006, and during the next five years and thereafter are as follows:

2007	\$	2,347,450
2008		2,151,350
2009		1,837,200
2010		1,384,575
2011		949,800
Thereafter		<u>1,158,125</u>
Total payments for unpaid prize installment obligations		9,828,500
Less imputed interest		<u>(1,372,776)</u>
Present value of prize installment obligations	\$	<u><u>8,455,724</u></u>

#### (6) Participation in the Multi-State Lottery

The Lottery is a member of the Multi-State Lottery (MUSL), which operates on-line games on behalf of participating state lotteries. Each MUSL member sells game tickets through its agents and makes weekly wire transfers to the MUSL in an amount equivalent to the member's share of the estimated grand prize liability. Each MUSL member pays lesser prizes directly to the winners. The MUSL operates the Powerball games, as well as the Powerplay feature associated with Powerball. Participating lotteries are required to maintain deposits with MUSL for contingency reserves to protect MUSL from unforeseen prize liabilities. The money in this reserve fund is refundable to MUSL members if the MUSL disbands or if a member leaves the MUSL Board.

The amount the Lottery had on deposit with MUSL, as of June 30, 2006 and 2005, equaled \$1,898,623 and \$1,700,747, respectively. These amounts are also reported as a liability on Lottery's balance sheet because they represent the amount to be paid to the State upon separation from the MUSL if the MUSL is not required to use a portion of the Lottery's reserves held by the MUSL.

Complete separate financial statements for the MUSL may be obtained by sending a written request to the Lottery's Administrative Office.

#### (7) Delaware Standardbred Breeder's Program

In March 1998, an amendment to the Legislation was passed by the General Assembly that established the Delaware Standardbred Breeder's Program (the Breeder's Program) for the purpose of promoting the Delaware harness racing industry. Under this amendment, the Lottery was initially required to withhold \$2,000,000 of funds annually (\$1,000,000 from the General Fund of the State and \$1,000,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program. Under an amendment signed in April 2004, the Lottery is required to withhold \$3,000,000 of funds annually (\$1,500,000 from the General Fund of the State and \$1,500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program.

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2006 and 2005

### (8) Contributions to the State of Delaware

As required, under the Legislation, net assets of the Lottery may not exceed \$1,000,000; therefore, the Lottery periodically transfers surplus funds to the State in accordance with the Legislation. For the years ended June 30, 2006 and 2005, the Lottery made the following contributions to the State of Delaware and, as of June 30, 2006 and 2005, had the following liabilities due to the State for excess earnings:

Amounts transferred during the fiscal year:		
General Fund	\$ 248,800,000	234,000,000
Department of Health and Social Services	1,548,214	1,598,174
Department of Agriculture	65,899,969	59,660,945
	<u>316,248,183</u>	<u>295,259,119</u>
Amounts accrued, beginning of year	(4,385,113)	(1,722,566)
Amounts due to the State, end of year:		
General Fund	—	—
Department of Health and Social Services	289,098	142,516
Department of Agriculture	3,833,531	4,242,597
	<u>4,122,629</u>	<u>4,385,113</u>
Amounts accrued, end of year		
Total contributions to the State of Delaware	\$ <u><u>315,985,699</u></u>	<u><u>297,921,666</u></u>

### (9) Revenue and Expenses by Game

The following revenue was recognized:

	<b>Year ended June 30</b>	
	<b>2006</b>	<b>2005</b>
On-line games:		
Play 3 Day	\$ 10,017,850	9,921,990
Play 3 Night	17,548,614	17,634,985
Play 4 Day	5,994,346	5,808,552
Play 4 Night	11,219,002	11,017,638
Multi Win Lotto	7,511,185	4,041,601
Lotto	—	11,509,065
Powerball	38,071,911	24,149,196
Powerplay	2,774,360	1,278,329
	<u>93,137,268</u>	<u>85,361,356</u>
Video Lottery, net	603,501,083	575,234,109
Instant	31,354,597	28,695,737
	<u><u>\$ 727,992,948</u></u>	<u><u>689,291,202</u></u>

# DELAWARE STATE LOTTERY

## Notes to Financial Statements

June 30, 2006 and 2005

The revenue, prize costs and commissions expense, by game type, are listed below:

	<u>On-line</u>	<u>Video Lottery, net</u>	<u>Instant</u>	<u>Total</u>
Year ended June 30, 2006:				
Revenue	\$ 93,137,268	603,501,083	31,354,597	727,992,948
Prize costs, net of reversions	<u>44,916,073</u>	<u>—</u>	<u>19,962,547</u>	<u>64,878,620</u>
	48,221,195	603,501,083	11,392,050	663,114,328
Commissions expense	<u>6,245,049</u>	<u>287,527,716</u>	<u>1,797,481</u>	<u>295,570,246</u>
Contribution margin per game	<u>\$ 41,976,146</u>	<u>315,973,367</u>	<u>9,594,569</u>	<u>367,544,082</u>
Year ended June 30, 2005:				
Revenue	\$ 85,361,356	575,234,109	28,695,737	689,291,202
Prize costs, net of reversions	<u>41,956,466</u>	<u>—</u>	<u>17,873,530</u>	<u>59,829,996</u>
	43,404,890	575,234,109	10,822,207	629,461,206
Commissions expense	<u>5,425,788</u>	<u>274,662,888</u>	<u>1,636,281</u>	<u>281,724,957</u>
Contribution margin per game	<u>\$ 37,979,102</u>	<u>300,571,221</u>	<u>9,185,926</u>	<u>347,736,249</u>

### (10) Payroll-Related and Other Benefits

All Lottery personnel are employees of the State and are covered by pension, health insurance and other employee benefit programs administered by agencies of the State. During 2006 and 2005, the Lottery incurred \$1,647,545 and \$1,569,045, respectively, of payroll-related costs, including pension, health insurance and other employee benefit costs, paid to various State of Delaware agencies responsible for the administration of benefit programs.

### (11) Retirement and Other Postemployment Benefits

The Lottery contributes to the State Employees' Pension Plan (the State Plan) established by the State to provide benefits for State employees. While the State Plan is an agent multiple employer public employee retirement system, the Lottery accounts for the plan as a cost-sharing multiple employer public employees retirement system since a separate valuation is not performed for the Lottery and the Lottery's only obligation to the plan is its required annual contributions. The State Plan is considered part of the State's financial reporting entity, and is not considered as part of the Lottery's reporting entity. The State Plan prepares separate financial statements, which can be obtained by writing to the State Board of Pension Trustees and Office of Pensions, McArdle Building, Suite #1, 860 Silver Lake Boulevard, Dover, Delaware 19904-2402.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2006 and 2005

The State Plan consists of several plans, which are managed by the State. The various plans have different vesting periods ranging from 5 to 20 years, various eligibility requirements and various benefits that are provided. The Lottery's required contributions, which equaled actual contributions made for the years ended June 30, 2006, 2005, and 2004, were \$162,331, \$139,226, and \$113,200, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2006 and 2005 equaled \$9,675 and \$7,835, respectively, and are included within amounts reported as Accounts Payable and Accrued Liabilities on the balance sheet.

#### (12) Risk Management

The Lottery stipulates in its vendor contracts that the vendors carry various insurance coverages such as property (video gaming machines and online terminals, etc.), general liability, errors and omissions, automotive and crimes. The Lottery's risks of losses related to workers' compensation, employee health care, automobile and a portion of property and casualty claims are insured internally by the State of Delaware.

#### (13) Commitments

The Lottery has entered into various contracts for services to be rendered relating principally to the operation of the Lottery's games. Under the gaming systems vendor contracts, the Lottery is committed to future obligations.

The Lottery is committed to 4.18% of online sales to its central system provider through November 2010 and 7.8987% of instant sales through November 2008. For video lottery, the Lottery is committed to 1% to the central system provider through November 2010 and a percentage ranging from 4.0% to 6.5% to the video lottery terminal providers through June 1, 2007.

The Lottery's commitments to gaming vendors, as described above, comprise the majority of the following commitments. The commitments to gaming vendors included in these commitments are based on management's sales projections for the respective years, as follows:

2007	\$ 45,654,000
2008	15,086,700
2009	12,985,000
2010	10,453,200
2011	3,600,300
Thereafter	—
	<u>\$ 87,779,200</u>